

Bankruptcy Law, an Economic Medicine: How Russia's New Bankruptcy Legislation Facilitated Recovery from the Nationwide Financial Crisis of August 17, 1998

Asya S. Alexandrovich

Follow this and additional works at: <http://scholarship.law.cornell.edu/cilj>

 Part of the [Law Commons](#)

Recommended Citation

Alexandrovich, Asya S. (2001) "Bankruptcy Law, an Economic Medicine: How Russia's New Bankruptcy Legislation Facilitated Recovery from the Nationwide Financial Crisis of August 17, 1998," *Cornell International Law Journal*: Vol. 34: Iss. 1, Article 3.
Available at: <http://scholarship.law.cornell.edu/cilj/vol34/iss1/3>

This Note is brought to you for free and open access by Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell International Law Journal by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

Bankruptcy Law, an Economic Medicine: How Russia's New Bankruptcy Legislation Facilitated Recovery From the Nationwide Financial Crisis of August 17, 1998

Asya S. Alexandrovich*

Introduction	95
I. The Birth and Formative Years of Russia's Bankruptcy Legislation	96
A. Development of Russia's Bankruptcy Laws	96
1. <i>Law on Insolvency of Enterprises</i>	97
2. <i>Law on Insolvency</i>	99
3. <i>Law on Insolvency of Credit Institutions</i>	103
B. The Financial Crisis of August 17, 1998	105
II. Exemplary Bankruptcy Cases	107
A. Bank MENATEP	107
B. Bank Imperial	110
III. Imperfections of the New Laws and Suggestions for Improvement	113
A. Imperfections of the Law on Insolvency	114
B. Imperfections of the Law on Insolvency of Credit Institutions	115
C. Conflicts of Laws	116
D. Implementation of Laws	117
Conclusion	117

Introduction

Free-market economy is about competition. Enterprises compete for market share, investments, and customers. Winning equals profits in the free-market game. Profitable winners squeeze the losers out of the market, leaving space for more efficient enterprises to grow and develop, as well as for new businesses that try to join the winning ranks. To make a competitive

* J.D. with Specialization in Int'l Legal Affairs 2001, Cornell Law School; B.A., summa cum laude 1998, Brandeis University.

market operational, free-market economies need an exit system.¹ In free-market countries, bankruptcy proceedings provide a uniform and effective exit mechanism that enables the economy to function properly.

To transition to a competitive free-market economy, a country must design a bankruptcy procedure that enables insolvent enterprises to leave the market. In its transition efforts, post-Communism Russia faced the challenging task of creating bankruptcy laws that were both efficient and compatible with the nation's cultural heritage. By synthesizing features from other countries' bankruptcy laws and utilizing the ancient method of trial and error, Russia's legislators finally drafted and executed the Law on Insolvency² and the Law on Insolvency of Credit Institutions.³ The aftermath of the financial crisis of August 17, 1998 that left the Russian economy in shambles tested these new laws.⁴ The crisis nearly obliterated Russia's banking sector: many banks were left insolvent, and most others had to struggle for survival.⁵ Fortunately, despite their imperfections, the progressive Law on Insolvency and Law on Insolvency of Credit Institutions helped the Russian banking sector to begin its recovery.

This Note examines Russia's new bankruptcy laws, the financial crisis of August 17, 1998, and the role of the new laws in revitalizing Russia's banking sector. Section I provides background on Russia's bankruptcy laws and the financial crisis of August 17 and introduces the main features of Russia's current bankruptcy legislation. Section II illustrates how the new laws operate by describing and analyzing two exemplary bankruptcy proceedings. These proceedings emphasize the restorative function that the new laws perform by allowing the liquidation and restructuring of insolvent or ailing banks. Finally, Section III considers the new laws' imperfections and suggests improvements. These improvements would make the new legislation a more effective weapon for fighting the aftermath of the crisis and may help prevent future countrywide financial disasters.

I. The Birth and Formative Years of Russia's Bankruptcy Legislation

A. Development of Russia's Bankruptcy Laws

Throughout the Communist regime, Russia lacked bankruptcy legislation.⁶ During the period of political and economic reformation, however, the absence of bankruptcy law threatened Russia's ability to reallocate

1. Professor Schumpeter labeled an exit system in competitive markets "creative destruction." RICHARD V. CLEMENCE & FRANCIS S. DOODY, *THE SCHUMPETERIAN SYSTEM* 63 (Augustus M. Kelley 1966) (1950). In accordance with his Pure Model, "the new firm is established at the expense of those already in existence." *Id.* at 10. Thus, the creation of new enterprises is made possible by the destruction of the old ones.

2. *Sobranie Zakonodatel'stva RF* [*Sobr. Zakonod. RF*], 1998, No. 2, Item 222 (Russ.).

3. *Sobr. Zakonod. RF*, 1999, No. 9, Item 1097.

4. *See infra* Part I.B.

5. Svetlana Petrova, *Banking: Dashed Hopes of 1999*, *MOSCOW NEWS*, Jan. 19, 2000, available at ISI Emerging Mkts., <http://www.securities.com>.

6. *Bankruptcy Regulations in Russia*, *RUSSIA EXPRESS-PERESTROIKA: EXECUTIVE BRIEFING* (Int'l Indus. Info.), Jan. 17, 1994, available at LEXIS, 2ndary Library, NWLTRS File.

resources since it was unable to reorganize insolvent enterprises effectively. No provision of Russia's existing legislation could "ensure the highest and best use of commercial assets following failure of a business or . . . permit the surgical restructuring of a business so that its healthy components can survive even if other aspects must be jettisoned."⁷ Lack of bankruptcy legislation also deterred much needed foreign investment, placing an intolerable burden on Russia's difficult transition to a free-market economy.⁸

1. *Law on Insolvency of Enterprises*

A Russian Presidential decree on June 14, 1992 attempted to control bankruptcies.⁹ The decree regulated the insolvency of state-owned enterprises but not other legal entities; "[t]his legislative act proved useless and existed for only eight months."¹⁰ Subsequently, following a long and heated series of debates, the Russian Parliament enacted the Law on Insolvency (Bankruptcy) of Enterprises on November 19, 1992, which went into effect on March 1, 1993.¹¹ Also, the government established the Russian Federal Bankruptcy Agency to prevent state-owned enterprises from going bankrupt.¹²

The legislation granted exclusive jurisdiction over insolvency cases to the courts of arbitration, Russia's commercial court system.¹³ This court system, including trial and appellate divisions, encompasses approximately two thousand judges throughout the Russian Federation.¹⁴ The Supreme Arbitration Court handles the final appeals for commercial, property, business, and insolvency issues.¹⁵

The Law on Insolvency of Enterprises regulated corporations and individuals.¹⁶

[It] defined the bankruptcy of a legal entity as "the inability to satisfy the demands of its creditors for the payment of goods (work, services), including the inability to make obligatory payments to the state and budget funds, if the debt owed is higher than the value of its property or if the structure of

7. Scott Horton, *The Death of Communism and Bankruptcy Reorganization*, AM. BANKR. INST. J., Apr. 1994, at 12, 12.

8. Petrova, *supra* note 5.

9. *Bankruptcy Regulations in Russia*, *supra* note 6.

10. *Id.*

11. *Id.*

12. G.P. IVANOV ET AL., ANTIKRIZISNOE UPRAVLENIE: OT BANKROTSTVA K FINANSOVAMU OZDOROVLENIYU [G.P. IVANOV ET AL., ANTI-CRISIS GOVERNANCE: FROM BANKRUPTCY TO FINANCIAL WELL-BEING] 6-8 (1995). The Agency was designed to represent the government's interests in the course of bankruptcy proceedings against state-owned enterprises, if these proceedings were to take place. The Agency was also supposed to monitor the financial condition of state-owned enterprises and to assist them in reorganizing and regaining solvency.

13. *Bankruptcy Regulations in Russia*, *supra* note 6.

14. Sidney B. Brooks, *Russia's March to a Market Economy Assisted by New Bankruptcy Law*, AM. BANKR. INST. J., June 1998, at 12, 12.

15. *Id.*

16. Horton, *supra* note 7, at 12.

the balance sheet is not satisfied.”¹⁷

A debtor could initiate bankruptcy proceedings by filing a voluntary petition with the court, or a creditor or prosecutor could initiate proceedings through an involuntary petition.¹⁸ The law used the so-called “balance sheet insolvency test,” a balance sheet analysis to evaluate the debtor’s ability to satisfy creditors’ claims.¹⁹ A court of arbitration made the declaration of bankruptcy.²⁰

The law provided the debtor three procedural options: reorganization, closing, or amicable settlement.²¹ Reorganization meant an attempt to restore the financial solvency of a business through external administration.²² The closing procedure applied where an enterprise demonstrated no possibility for future recovery.²³ In cases of closings and failed reorganizations, the court would declare the debtor bankrupt and satisfy creditors’ claims through the sale of the debtor’s assets.²⁴

An amicable settlement referred to an agreement between the debtor and its creditors to decrease, postpone, or discharge the debtor’s obligations.²⁵ The parties could reach this settlement at any stage of the proceeding prior to a court’s final declaration of bankruptcy.²⁶ However, the settlement could only modify claims of creditors of the fourth rank or below, and at least two-thirds of the involved claimants had to approve the settlement’s terms.²⁷ Also, the law required the court of arbitration’s approval,²⁸ and within two weeks of the court’s approval, the debtor had to repay at least 35% of its obligations.²⁹ Furthermore, the court could annul an amicable settlement at any time for a number of reasons and resume

17. Peter A. Maximov, *Russia’s New Bankruptcy Law Is a Step Forward*, RUSS. & COMMONW. BUS. L. REP. (LRP Publ’ns), Apr. 22, 1998, available at LEXIS, 2ndary Library, NWLTRS File.

18. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222.

19. Sidney B. Brooks, *A New Insolvency Law for Russia*, AM. BANKR. INST. J., June 1995, at 36.

20. *Bankruptcy Regulations in Russia*, *supra* note 6.

21. *Id.*

22. *Id.*

Reorganisation includes external administration of a debtor’s property or financial “healing.” This type of procedure is applied in cases when it is possible to restore an enterprise’s solvency. In external administration, a court of arbitration appoints an arbitration manager to be in charge of the debtor enterprise. In the case of “healing”, interested third persons help the debtor.

Id.

23. *Id.* (“If [reorganization] measures do not produce tangible results within a fixed term, a debtor enterprise is declared bankrupt and closed down forcibly. Competitive bidding for the company is begun and the creditors’ demands are met from the resulting funds.”).

24. *Id.*

25. IVANOV ET AL., *supra* note 12, at 230.

26. *Id.*

27. *Id.*; see also *infra* text accompanying note 32 (describing the prioritization order for creditors’ claims).

28. IVANOV ET AL., *supra* note 12, at 230.

29. *Id.* at 231.

bankruptcy proceedings.³⁰ These numerous restrictions rendered the amicable settlement, in effect, a senseless option for most debtors and creditors.

The Law on Insolvency of Enterprises also established a prioritization system for repaying creditors.³¹ After the payment of expenses for the asset sale and the enterprise's operation, the claims were to be satisfied in the following order: (1) tort claims; (2) wages, severance pay, and royalties; (3) secured creditor claims; (4) taxes and other government obligations; and (5) all other claims.³² In reality, however, secured creditors were repaid first because they received their collateral prior to the sale of assets.³³

The Law on Insolvency of Enterprises constituted the first brick in the foundation of Russia's bankruptcy system. While its main concepts were effective, the law had numerous theoretical and practical gaps; key provisions were not well conceived.³⁴ The law failed to provide detailed definitions of essential terms or lay out the procedures for implementation with sufficient clarity.³⁵ Furthermore, the mechanism for the law's operation was not in place; judges were unprepared, and qualified external arbitration managers were lacking.³⁶ Because the Law on Insolvency of Enterprises was incomplete and difficult to implement, few bankruptcy proceedings against minor enterprises were initiated while it was in force.³⁷

2. *Law on Insolvency*

Because of the Law on Insolvency of Enterprises' flaws, the Russian State Duma's Committee on Property, Privatization, and Business Activities drafted a new bankruptcy law in 1997.³⁸ President Yeltsin signed the new Law on Insolvency (Bankruptcy) on January 11, 1998, and it became effec-

30. *Id.* at 231-32. The court could annul an amicable settlement at any time at a creditor's request, regardless of whether the creditor participated in the settlement. *Id.* The creditor had to allege that the debtor misstated the value of its assets. *Id.* If the allegation proved true, the court annulled the settlement. *Id.* The court could also cancel an amicable settlement if any party failed to comply with the settlement's terms, if the debtor's financial condition continued to deteriorate, or if the debtor's actions while the settlement was in force were detrimental to its creditors. *Id.* Any action that diminishes the debtor's assets or the debtor's future ability to repay its debts would likely be considered detrimental by the court. *Id.*

31. Brooks, *supra* note 14, at 12.

32. *Russia's New Bankruptcy Law Workable but Flawed*, BCD NEWS & COMMENT (LRP Publ'ns), Feb. 24, 1998, available at LEXIS, 2ndary Library, NWLTRS File.

33. *Bankruptcy Regulations in Russia*, *supra* note 6 ("[T]he property subject to a mortgage is not included in the property sold in competitive bidding.").

34. For instance, the procedure for amicable settlements illustrates the problems with the law. See *supra* notes 25-30 and accompanying text.

35. Brooks, *supra* note 19, at 37. For example, the law failed to define adequately the secured creditors class or lay out the procedure for protecting secured claims with respect to depreciation of collateral. *Id.* The law also failed to specify how a debtor fulfills its obligations regarding notice to creditors and other due process concerns. *Id.*

36. Horton, *supra* note 7, at 12, 31.

37. IVANOV ET AL., *supra* note 12, at 6, 236-50.

38. See *Russian Duma Prepares New Bankruptcy Law*, RUSS. & COMMONW. BUS. L. REP. (LRP Publ'ns), Mar. 26, 1997, available at LEXIS, 2ndary Library, NWLTRS File.

tive on March 1, 1998.³⁹ The law provided dramatic improvements over prior legislation in several respects.

First, the law replaced the "balance sheet insolvency test"⁴⁰ with two simple criteria: (1) three months must pass between the legal entity's failure to pay a debt and the commencement of a bankruptcy proceeding;⁴¹ and (2) the debt must exceed 500 times the minimum monthly wage established by law.⁴²

Second, the bankruptcy procedures under the Law on Insolvency of Enterprises—reorganization, closing, and amicable settlement—collapsed into a unitary bankruptcy procedure for "virtually all enterprises, [for] individual entrepreneurs, and even [for] consumer bankruptcies."⁴³

Third, the Law on Insolvency of Enterprises only authorized courts to void preferential transactions—transactions that prefer one creditor over another.⁴⁴ The new law granted courts the discretion to void any of the debtor's transactions during the bankruptcy proceeding, if the court considered the transaction detrimental to creditors.⁴⁵

Fourth, the new bankruptcy procedure's details filled many gaps in the Law on Insolvency of Enterprises. "The old law had 30 or 40 sections' . . . The new law has about 190 different sections."⁴⁶ Therefore, the Law on Insolvency provided more guidance for courts and potential bankrupts.

Fifth, the law deterred officers and managers from filing a voluntary bankruptcy petition in an untimely manner.⁴⁷ Their failure to promptly file could result in "criminal penalties, personal liability for the debtor's business debt, and disqualification from serving as a business proprietor or manager in the future."⁴⁸

Finally, the Law on Insolvency increased the requisite qualifications for "arbitration managers" who acted as temporary supervisors, external managers, and receivers.⁴⁹ The law contemplated an effort to raise the

39. Maximov, *supra* note 17; *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32.

40. *Supra* note 19 and accompanying text.

41. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 3. This criteria measures the debtor's ability to satisfy the claims of its creditors.

42. *Id.* art. 5; see also Maximov, *supra* note 17.

43. *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32; see *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 1. The only exception to the unitary procedure is for bankruptcies of credit institutions. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 141; see also *Sobr. Zakonod. RF*, 1999, No. 9, Item 1097.

44. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 78; *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32.

45. *Id.* A court would likely consider any transaction that diminishes the debtor's assets or the debtor's future ability to repay its debts following reorganization detrimental to creditors.

46. *Id.* (quoting Jean Brough of Baker & McKenzie in Moscow); see *Sobr. Zakonod. RF*, 1998, No. 2, Item 222.

47. Brooks, *supra* note 14, at 12-13.

48. *Id.*; see *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 9.

49. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 19; Maximov, *supra* note 17.

managers' professionalism and efficiency.⁵⁰ A court could only appoint as an arbitration manager a private person registered as an individual entrepreneur and specially licensed through a training course before March 1, 1999.⁵¹

The Law on Insolvency mapped out an innovative three-stage process for most voluntary and involuntary bankruptcies: observation, external management, and competition proceedings.⁵² During the observation period, the court appoints a temporary supervisor.⁵³ The debtor remains in control of his business, but the temporary supervisor monitors all transactions and conducts a financial analysis of the company.⁵⁴ "He or she also looks for signs of premeditated bankruptcy and fictitious bankruptcy, which are crimes under Articles 196 and 197 of the 1997 Russian Criminal Code."⁵⁵ Thus, the temporary supervisor acts as both an analyst and a law-enforcement agent.

A major responsibility of the temporary supervisor is to preserve the bankruptcy estate until the court of arbitration makes its final insolvency decision. The supervisor actively evaluates the debtor's transactions to ensure that the transactions do not worsen the enterprise's financial position.⁵⁶ The temporary supervisor has the right to approve or reject the debtor's major deals.⁵⁷ Moreover, the supervisor may ask the court "to void transactions by the debtor, to forbid the debtor from conducting any transactions without his concurrence, or to order the transfer of property of the debtor to a third party for safekeeping."⁵⁸ The temporary supervisor also may seek permission from the court "to dismiss certain individuals from the governing body of the debtor-company if he believes that the actions of such individuals are causing material damage to the company."⁵⁹

Another crucial task for the temporary supervisor is the identification and notification of creditors.⁶⁰ The supervisor compiles a list of creditors, notifies them of the bankruptcy action, and organizes their first meeting.⁶¹

50. Maximov, *supra* note 17.

51. *Id.*

52. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 23.

53. *Id.* art. 59.

54. *Id.* arts. 57-58, 61-62.

55. *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32.

56. *Id.*; *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, arts. 57-58.

57. *Id.* The Law on Insolvency defines major deals as involving more than 10% of the debtor's assets or sales of the debtor's real estate. M.V. Telyukina, *Osobennosti Novogo Zakonodatel'stva o Nesostoyatel'nosti (Bankrotstve) (Special Features of the New Law on Insolvency (Bankruptcy))*, *ZHURNAL ZAKONOD.*, May 7, 1999, available at Garant, http://www.garant.ru/jorn/leg_7_05_99.html.

58. *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32; see *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 60.

59. Maximov, *supra* note 17; see *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 60. For instance, the temporary supervisor is likely to ask the court to dismiss a manager who steals company assets or makes highly speculative investments.

60. *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32; see *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, arts. 61, 63-64.

61. *Id.*

"At that meeting, creditors decide whether an outside manager should be appointed to reorganize the company, if an amicable agreement can be reached, or if the enterprise needs to be liquidated."⁶² After this process, the court takes the creditors' vote, as well as the temporary supervisor's report, into consideration when making its final decision on the enterprise's fate.⁶³

The creditors' committee elected to represent all qualified creditors then nominates an external arbitration manager.⁶⁴ If the court appoints the nominated manager, that manager takes full control of the enterprise and attempts to achieve solvency.⁶⁵ The external manager drafts an "external management plan" to present at the creditor meeting.⁶⁶ The creditors can reject the manager's proposal and apply to the court for a declaration of bankruptcy.⁶⁷ But if the majority of creditors accept the plan, the external manager assumes full control of the debtor-company.⁶⁸

During external management, the law imposes a moratorium on satisfying creditors' claims.⁶⁹ Although the Law on Insolvency of Enterprises included a moratorium provision, "its effectiveness was significantly reduced by the fact that the debtor was supposed to pay fines and penalties for nonpayment of the debt during the time of the moratorium."⁷⁰ The Law on Insolvency prohibits fines or penalties during the period of external management for nonpayment of debts that exceed the level set in Article 395 of the Russian Federation Civil Code.⁷¹ All fines accumulated before external management, however, can be collected when the external management period ends.⁷²

For most enterprises, external management lasts for twelve to eighteen months.⁷³ If the external manager fails to restore solvency, a receiver appointed by the court liquidates the enterprise and satisfies creditors' claims on a pro rata basis from the proceeds of the sale.⁷⁴ Alternatively,

62. *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32.

63. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 67; Maximov, *supra* note 17.

64. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, arts. 68, 71; Maximov, *supra* note 17.

65. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, arts. 68-69, 72, 74; Maximov, *supra* note 17.

66. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, arts. 74, 82; Maximov, *supra* note 17.

67. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 83; Maximov, *supra* note 17.

68. *Id.*

The external manager has the right to conclude transactions on behalf of the debtor-company as long as no transaction exceeds 20 percent of the value of the company's assets. If a transaction is in accordance with the external manager's plan and is approved by the meeting of creditors, the external manager has a right to sign off on the transaction regardless of its value.

Maximov, *supra* note 17.

69. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 70; Maximov, *supra* note 17.

70. Maximov, *supra* note 17.

71. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 70; Maximov, *supra* note 17. This level equals the interest rate set by the Central Bank of the Russian Federation.

72. *Id.*

73. *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32.

74. *Id.*; see *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, arts. 99, 101, 112.

individuals may keep property that the Law on Insolvency has exempted.⁷⁵

The order for satisfaction of debts remains the same as under the Law on Insolvency of Enterprises.⁷⁶ Secured creditors, however, can no longer receive their collateral back, "[r]ather, they have a claim over all the assets up to the value of their security interest, but only after tort claims and wage arrears have been paid off."⁷⁷

Overall, the Law on Insolvency is a formidable attempt to establish a coherent, logical, and effective insolvency procedure that would facilitate the Russian economic transition to a free market. The law is designed, however, to be used in conjunction with more specialized bankruptcy legislation covering the insolvency of credit institutions. A law outlining the bankruptcy procedures for credit organizations finally passed in 1999, joining the Law on Insolvency in its quest to transform Russia's economy.

3. *Law on Insolvency of Credit Institutions*

As specified in Article 141, the Law on Insolvency only applies to credit institutions when "the federal law on insolvency (bankruptcy) of credit organizations" is inapplicable.⁷⁸ The law cited in Article 141 did not exist when the Law on Insolvency took effect. In fact, the Law on Insolvency of Credit Institutions had no analogue in earlier Russian legislation. Prior to 1999, insolvent banks were treated the same as all other bankrupt entities. Accordingly in 1998, bank bankruptcies would have been governed by the Law on Insolvency. The Law on Insolvency, however, specified that specialized legislation covered insolvent credit institutions, even though that legislation did not exist in 1998.⁷⁹

Following completion of the Law on Insolvency, the Duma began deliberating the proposed bankruptcy law for credit institutions. The financial crisis of August 17, 1998 rendered many Russian banks insolvent, making the need for the law more pressing than ever.⁸⁰ Unfortunately, among the Duma and top government officials, political bickering ranked above the country's economic well-being, and, as a result, the legislation was not enacted until seven months after the crisis.⁸¹

On January 15, 1999, the Russian Duma voted to override President Yeltsin's veto of the Law on Insolvency of Credit Institutions.⁸² The Federation Council voted similarly on February 18.⁸³ These votes obligated the President to sign the legislation, which he did on March 1, 1999.⁸⁴

75. Brooks, *supra* note 14, at 12-13.

76. *Supra* notes 31-33 and accompanying text; see *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, arts. 106-11.

77. *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32.

78. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 141.

79. *Id.*

80. *Supra* Part I.B.

81. *Yeltsin Forced to Sign Bank Insolvency Law*, *RUSS. & COMMONW. BUS. L. REP. (LRP Publ'ns)*, Mar. 10, 1999, available at LEXIS, 2ndary Library, NWLTRS File.

82. *Id.*

83. *Id.*

84. *Id.*

The Law on Insolvency of Credit Institutions is based on the Law on Insolvency.⁸⁵ It establishes similar procedures, but modifies them specifically for credit institutions.⁸⁶ For instance, while the order for satisfaction of claims is the same as under the Law on Insolvency, account holders and judgment creditors receive first priority.⁸⁷ The law grants the Central Bank of the Russian Federation the authority to begin and supervise bankruptcy proceedings.⁸⁸ A bankruptcy action against a bank can only be initiated after the Central Bank revokes the institution's banking license.⁸⁹ As with other bankruptcy cases, the courts of arbitration handle the proceedings.⁹⁰

Most practitioners believe that this new law helped to restore Russia's banking sector after the August 1998 financial crisis.⁹¹ They consider definite bank insolvency procedures and clarifications of creditors' ranking and treatment the Law on Insolvency of Credit Institutions' greatest features.⁹² Following the law's passage, the Central Bank developed special qualifications for temporary bank managers.⁹³

The government created an Agency for Restructuring Credit Organizations (ARKO), which began operation in April 1999.⁹⁴ The government envisioned ARKO taking direct control of ailing and failed banks to revitalize them.⁹⁵ As of today, however, ARKO lacks the necessary resources to complete its task, and a power struggle with the Central Bank continually impairs ARKO's work.⁹⁶

The Law on Insolvency of Credit Institutions remains under review for clarification through a series of amendments and normative acts.⁹⁷ How-

85. Compare *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, with *Sobr. Zakonod. RF*, 1999, No. 9, Item 1097.

86. *Sobr. Zakonod. RF*, 1999, No. 9, Item 1097.

87. *Id.* art. 49; Sam Greene, *Menatep Payout Preempts Bankruptcy*, *Russ. J.*, Sept. 27, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

88. *Sobr. Zakonod. RF*, 1999, No. 9, Item 1097, arts. 35, 37.

89. *Id.* art. 36; *Russia Regulations: Bankruptcy Law Comes Into Force*, *ECONOMIST INTELLIGENCE UNIT LTD.*, June 7, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

90. *Sobr. Zakonod. RF*, 1999, No. 9, Item 1097, art. 34.

91. *Yeltsin Forced to Sign Bank Insolvency Law*, *supra* note 81.

92. Compare *supra* notes 31-37 and accompanying text, with *supra* notes 85-90 and accompanying text.

93. *Central Bank Instructions on Bankruptcy Law*, *BANKS & EXCHS.*, Mar. 15, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

94. *Russia Regulations: Bankruptcy Law Comes Into Force*, *supra* note 89.

95. *Id.*

96. See *id.* ARKO is supposed to work with the Central Bank to control the Russian banking sector's revitalization. *Id.* The Central Bank, however, is unwilling to share its power over ailing Russian banks with the government agency. See *id.* Thus, the Bank often refuses to cooperate with ARKO, hindering its operation. See *id.*

97. 20:37 MST *State Duma Approves Bill of Changes in Law on Lending Institutions Bankruptcy*, *PRIME-TASS NEWS WIRE*, Sept. 15, 1999, available at ISI Emerging Mkts., <http://www.securities.com>; *Amendments to the Law on Bank Insolvency*, *RUSS. BUS. MONITOR*, Oct. 11, 1999, available at ISI Emerging Mkts., <http://www.securities.com>; *Government Guides Banking Legislation*, *INFO-NOVA PRESS DIG.*, Oct. 29, 1999, available at ISI Emerging Mkts., <http://www.securities.com>; *Government Proposes Implementation of Additional Indication of Crediting Organizations' Bankruptcy*, *RUSS. BUS. MONITOR*, Nov. 15, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

ever, the government is considering no substantive changes. The current clarifications are paramount to ensure the law's proper operation in effectively combating, or perhaps preventing, a future financial crisis similar to the August 17, 1998 crisis.

B. The Financial Crisis of August 17, 1998

The August 17, 1998 financial crisis tested the Law on Insolvency and prompted the much needed Law on Insolvency of Credit Institutions' passage. When Russia's entire financial sector, the banking sector in particular, collapsed, driving the country into recession, the country used the Law on Insolvency to begin the restoration process. After closing the insolvent banks, the second phase of the restoration process required the Central Bank to initiate new proceedings against insolvent credit organizations and required the application of the Law on Insolvency of Credit Institutions to the cases in progress, such as the Bank Imperial bankruptcy.⁹⁸

On August 17, 1998, the Russian government stopped paying debts from maturing nine-month T-bills, known as GKO (gosudarstvennye kratkosrochnye obligatsii).⁹⁹ The government had issued GKO since 1993, constantly increasing its debt and building a so-called pyramid, which finally collapsed on August 17.¹⁰⁰ Russian banks bought a significant portion of the GKO, which were considered a relatively risk-free, liquid investment.¹⁰¹ The banks financed GKO purchases "by borrowing from foreign banks through repo contracts, in the process exposing themselves to substantial currency risk."¹⁰²

Beginning April 1, 1998, the government unsuccessfully tried to raise enough money to meet current obligations by selling newly issued debt.¹⁰³ But traders knew the government's dire situation, bid low, and received very high yields.¹⁰⁴ The government's efforts to keep the ruble exchange rate stable by tightening monetary policy drove the interest rate on GKO beyond one hundred percent.¹⁰⁵ GKO prices fell rapidly; thus, the government could not raise enough money and had to dip into monetary reserves to cover daily expenses.¹⁰⁶

On August 17, the government exhausted these reserves and ceased payments on GKO, effectively declaring its insolvency.¹⁰⁷ When the government abandoned all attempts to defend the exchange rate, the ruble

98. *Infra* Part II.

99. Gary Peach, *A Year After the Crash: Pyramid Crash Began on Fool's Day*, *Moscow Times*, Aug. 17, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

100. *Id.*

101. *Id.*

102. Press Release, U.N. Econ. Comm'n for Eur., *The Russian Crisis* (Oct. 16, 1998), available at <http://www.unece.org/press/98gen12e.htm> [hereinafter *The Russian Crisis*].

103. Peach, *supra* note 99.

104. *Id.*

105. *The Russian Crisis*, *supra* note 102.

106. Peach, *supra* note 99.

107. *Id.*

depreciated by more than twenty-five percent.¹⁰⁸ Given the ruble's devaluation, most Russian banks that had to repay GKO-financing loans in dollars became unable to meet their obligations.¹⁰⁹ The government's moratorium on its own debt collapsed Russia's financial system.

Numerous economic and political events that halted the Russian economy's growth culminated in the crisis.¹¹⁰ Years of economic reform deformed and weakened the Russian economic system.¹¹¹ Many analysts consider the Duma deputies "guilty for August 17 more than anybody else" because, on a yearly basis, they had been "inflating the budget and preventing expenditures from being curtailed, thus forcing the state to borrow money."¹¹² Others believe that a series of top government officials' actions in 1998 precipitated the crisis.¹¹³ In the words of Grigory Yavlinsky, Professor of Economics and leader of the Yabloko Duma faction:

What [the officials] did was stop financing of non-competitive sectors of economy . . . As of early 1998 already, barter, monetary surrogates, securities, etc., accounted for 75% of the economic turnover. . . .

The money-free system prevented collection of taxes. As a result, they could not form the state budget properly.¹¹⁴

The budget deficit led to extensive government borrowing, domestically and abroad, creating the "short-term state bonds pyramid" that collapsed on August 17, 1998.¹¹⁵

Russian banks also contributed to the crisis. The Central Bank failed to warn the government about the dangers of its actions and helped the government implement flawed economic policies.¹¹⁶ Consequently, other Russian banks chose not to invest depositors' money in the economy like most Western banks.¹¹⁷ Instead, they transferred all money to accounts abroad or invested in securities, further depleting Russia's monetary holdings.¹¹⁸

In summary, whatever its causes, the August 1998 crisis indisputably left the Russian economy in shambles. Many Russian banks became insolvent in the wake of the crisis.¹¹⁹ Fortunately, Russia's new bankruptcy laws provided the necessary tools to begin rebuilding the economy, the

108. The Russian Crisis, *supra* note 102.

109. *Id.*

110. *Id.*

111. Ludmila Yudina, *After the Collapse*, WHAT THE PAPERS SAY, Mar. 3, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

112. Alexander Budberg, *The Culprits of the August 17 Events Found*, WHAT THE PAPERS SAY, Mar. 17, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

113. *Before and After August 17th*, WHAT THE PAPERS SAY, Nov. 19, 1998, available at ISI Emerging Mkts., <http://www.securities.com>.

114. *Id.* (omissions in original).

115. *Russia's New Bankruptcy Law Workable but Flawed*, *supra* note 32.

116. Yudina, *supra* note 111.

117. *Before and After August 17th*, *supra* note 113 ("Short-term financial machinations and not investments in economy are what the Russian banking system is all about.").

118. Yudina, *supra* note 111.

119. *The Central Bank Continues Revoking Bank Licenses*, SKRIN News, Oct. 11, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

banking sector in particular. These laws allowed the Central Bank and creditors to initiate bankruptcy proceedings against insolvent credit institutions and ultimately close them down. Eliminating bankrupt institutions provided the necessary room for expansion by solvent banks and for creation of new credit institutions, facilitating the vital process of creative destruction in a market economy.¹²⁰

II. Exemplary Bankruptcy Cases

The Law on Insolvency of Credit Institutions allowed the Central Bank of Russia to mount a swift attack on ailing Russian banks. As illustrated by the following exemplary bankruptcy proceedings under the law, the legislature should have acted sooner. Nevertheless, the Law on Insolvency of Credit Institutions helped Russia take a tremendous step toward stabilizing its banking sector, demonstrating that late is better than never at all.

A. Bank MENATEP

On May 18, 1999, the Central Bank of Russia filed a petition with the Moscow Court of Arbitration to declare Bank MENATEP bankrupt.¹²¹ The Central Bank's petition initiated the first bankruptcy proceeding under the Law on Insolvency of Credit Institutions that ended in a declaration of bankruptcy.¹²² The petition followed the revocation of MENATEP's banking license on May 17, 1999 for failure to meet creditors' claims and compulsory obligations.¹²³

At first, the court rejected the Central Bank's petition.¹²⁴ "The court grounded the declination on the fact that presented authority of the person [who] signed the application was inauthentic."¹²⁵ Following a series of appeals by the Central Bank, however, the Moscow Court of Arbitration allowed the Bank to resubmit its petition and initiated the bankruptcy proceeding against MENATEP on June 3, 1999.¹²⁶ The court closed Bank MENATEP and imposed supervision procedures, appointing Alexei Karmanov the provisional manager.¹²⁷ On July 14, 1999, the court instructed Karmanov to act as a temporary head of MENATEP following its president's removal for his non-cooperation with the bankruptcy

120. CLEMENCE & DOODY, *supra* note 1, at 10.

121. 13:46 MST CBR has Filed Bankruptcy Lawsuit Against Bank MENATEP with Moscow Arbitration Court, PRIME-TASS NEWS WIRE, May 19, 1999, available at ISI Emerging Mkts., <http://www.securities.com>. The Central Bank filed the petitions under article 35 of the Law on Insolvency of Credit Institutions. *Id.*

122. 17:01 MST Court Rejects Central Bank's Application for MENATEP's Bankruptcy (Follow-Up), PRIME-TASS NEWS WIRE, May 26, 1999, available at ISI Emerging Mkts., <http://www.securities.com> [hereinafter *Court Rejects Application*].

123. MENATEP Bankruptcy Case Starts, RUSS. BUS. MONITOR, June 7, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

124. *Court Rejects Application*, *supra* note 122.

125. *Id.*

126. MENATEP Bankruptcy Case Starts, *supra* note 123.

127. *Id.*

administration.¹²⁸

Bank MENATEP had been the fifth-largest Russian bank prior to its insolvency in the wake of the August 1998 crisis.¹²⁹ The "bank reaped the benefits of lucrative government contracts authorizing it to handle state accounts."¹³⁰ MENATEP also managed to attract major companies and banks as creditors.¹³¹ Although both MENATEP's debts and assets equaled approximately forty billion rubles when the proceedings began, the losses from defaulted domestic loans brought its assets down to between 4.3 and 7.9 billion rubles, making it insolvent.¹³² The Law on Insolvency of Credit Institutions' passage made MENATEP's closing possible. Unfortunately, due to the delay, by June 1999, MENATEP remained a mere shell "whose assets had been stripped and transferred to affiliates months ago."¹³³ "Much of Menatep's business ha[d] been transferred to Menatep St. Petersburg, an independent 'sister' bank that continues to operate."¹³⁴ Moreover, some of MENATEP's assets had been hidden abroad.¹³⁵

Swifter legislative action enacting the Law on Insolvency of Credit Institutions could have prevented this transfer of assets, but the Duma's political bickering over ARKO's powers and the law's details provided MENATEP's managers the time needed to shield assets from creditors. The immediate supervision procedures outlined in the Law on Insolvency of Credit Institutions¹³⁶ would prevent shielding of assets.

Following the law's procedure, on July 29, 1999, the Moscow Court of Arbitration held a hearing to determine MENATEP's fate.¹³⁷ The Central Bank, as well as Karmanov, argued for the speedy liquidation of MENATEP's assets, claiming that restoration of solvency was impossible.¹³⁸ A MENATEP spokesman protested liquidation, presenting evidence that the debts amounted only to 31.4 million rubles, not the 1.2 billion the Central Bank claimed.¹³⁹ The court chose to postpone its decision until

128. *Court Removes MENATEP President*, INFO-NOVA PRESS DIG., July 14, 1999, available at ISI Emerging Mkts., <http://www.securities.com> ("The court instructed Karmanov to act as head of the bank and ordered the former head to transfer all financial and economic documents, stamps, material and other valuables to the temporary administrator.").

129. Greene, *supra* note 87.

130. Catherine Belton, *Court Declares Menatep Bankrupt*, MOSCOW TIMES, Sept. 30, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

131. MENATEP's major creditors included: the oil company Yukos, the financial industrial group Rosprom, the state-owned Vneshekonombank, the Central Bank's Paris-based subsidiary Eurobank, CS First Boston, the Italian bank San Paolo, and the German Bayerische Bank. *Id.*; Catherine Belton, *Menatep Creditors Vote to Close Bank*, MOSCOW TIMES, Sept. 22, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

132. Belton, *supra* note 130.

133. *Banks Closed*, RUSS. BUS. NEWS, June 17, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

134. Belton, *supra* note 131.

135. *Id.*

136. *Sobr. Zakonod. RF*, 1999, No. 9, Item 1097.

137. *Hearing of MENATEP Bankruptcy Case Postponed*, RUSS. BUS. MONITOR, Aug. 2, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

138. *Id.*

139. *Id.*

September 29, 1999 at the suggestion of MENATEP's creditors.¹⁴⁰

MENATEP's creditors voted overwhelmingly to liquidate prior to the second hearing.¹⁴¹ After the vote and prior to any decision on MENATEP's fate, its shareholders used personal funds to compensate some of MENATEP's account holders.¹⁴² Perhaps the owners were trying to demonstrate that MENATEP cared about its account holders and deserved a chance at recovery, or perhaps MENATEP's owners were trying to ensure the success of future ventures by securing the trust and respect of the general public, and possibly the court and the government. Despite the shareholders' efforts, the court declared MENATEP bankrupt on September 29, 1999, the first institution declared bankrupt under the Law on Insolvency of Credit Institutions.¹⁴³ The court appointed Karmanov MENATEP's receiver and ordered liquidation.¹⁴⁴

A few of MENATEP's owner-creditors, specifically Yukos and MFO MENATEP, were and continue to be unhappy with the court's decision.¹⁴⁵ They consistently attempt to stop the liquidation and intend to reorganize, despite the creditors committee's decision to proceed with the bankruptcy sale.¹⁴⁶ On December 16, 1999, Yukos and MFO MENATEP voiced their readiness "to gradually repay the bank's debts to the state budget."¹⁴⁷ According to analysts, this announcement sought to win state legislators' support in the struggle to stop MENATEP's liquidation.¹⁴⁸

In December 1999, Yukos's spokespersons were unsure whether the oil company planned to file a formal appeal. If Yukos files an appeal, there is a slim chance that the appellate courts will reverse the court's decision.¹⁴⁹ Thus, while MENATEP's ultimate fate remains uncertain, the liquidation continues, demonstrating that the Law on Insolvency of Credit Institutions provides tangible benefits by giving the Central Bank a weapon to revive Russia's banking sector.

140. *Id.*

141. Belton, *supra* note 131.

142. Greene, *supra* note 87; *Menatep Starts Paying Clients*, MOSCOW TIMES, Sept. 28, 1999, available at ISI Emerging Mkts., <http://www.securities.com> ("Menatep began paying out savings to its private depositors The bank's move unlocks some dollars 80 million worth of accounts that were unilaterally frozen after the August 1998 financial crisis, leaving private depositors without access to their savings.").

143. A. Lebedev, *New Conflict of Interests is Arising in MENATEP Bank, Which Was Declared Insolvent in the End of September*, BANKS & EXCHS., Dec. 20, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

144. *Id.*

145. *Id.*

146. *Id.*

147. *YUKOS Equates State with Deceived Depositors*, INFO-NOVA PRESS DIG., Dec. 16, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

148. *Id.*

149. Lebedev, *supra* note 143. For instance, a finding that the judges who declared MENATEP bankrupt had an interest in the proceeding or were bribed might warrant reversal.

B. Bank Imperial

Unlike MENATEP's bankruptcy proceedings, Bank Imperial's case started before the Law on Insolvency of Credit Institutions' enactment. The court conducted these proceedings under the Law on Insolvency until the Law on Insolvency of Credit Institutions took effect. The switch of governing law caused judicial confusion, illustrating a conflict between the bankruptcy laws.

Two entrepreneurs, Alexander Mamut and Andrei Glorizov, founded Bank Imperial in the early 1990s.¹⁵⁰ The founders attracted some prominent investors and shareholders from large fuel and energy enterprises, including Gazprom, the Fuel and Energy Ministry, Zarubezhneft, and LUKoil.¹⁵¹ This rich clientele ensured Imperial's prosperity. Imperial not only had great investors but also a resourceful top executive, Sergei Rodionov, "who had worked as deputy chairman of the Central Bank [of the Former Soviet Union] from April through December 1991."¹⁵²

Supported by the fuel and energy sector and led by Rodionov, Imperial soon became Russia's fourteenth-largest bank.¹⁵³ It grew by acquiring whole subsidiaries and partial stakes in other banks.¹⁵⁴ It even managed to buy a stake in "East-West United, a Russian state bank based in Luxembourg," "getting a residence permit in the center of Europe."¹⁵⁵

Imperial's prosperity, however, ended in 1998. "The first blow was the partial transfer of Gazprom accounts to Gazprombank."¹⁵⁶ A series of smaller blows followed. In July 1998, when the prices of stocks and state securities spiraled downward, Imperial's working capital dropped from one billion rubles to six hundred million.¹⁵⁷ Outside observers concluded that Imperial would be unable to meet its obligations.¹⁵⁸ On July 23, 1998, Rodionov resigned.¹⁵⁹ After the first week of August 1998, Imperial could no longer meet its credit obligations.¹⁶⁰ On August 14, 1998, it stopped servicing clients.¹⁶¹ The Central Bank finally revoked Imperial's banking license on August 25, 1998.¹⁶²

On September 30, 1998, the advertising agency Cabrio, one of Imperial's creditors, petitioned the Moscow Court of Arbitration to begin bank-

150. Irina Yasina, *How Bank Imperial Got Its License Back*, MOSCOW NEWS, June 23, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

151. *Id.*

152. *Id.*

153. IN BRIEF: *Imperial Loses Appeal*, MOSCOW TIMES, Apr. 6, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

154. Yasina, *supra* note 150.

155. *Id.*

156. *Id.*

157. Yevgenia Borisova, *Bank Imperial Granted Bankruptcy Postponement*, MOSCOW TIMES, Apr. 16, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

158. Yasina, *supra* note 150.

159. *Id.*

160. *Id.*

161. *Id.*

162. *Creditors' Claims Against Imperial Bank Top 5 Bln Rubles*, BANKS & EXCHS., Apr. 12, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

ruptcy proceedings.¹⁶³ The court implemented provisional observation of Imperial and appointed Vyacheslav Medvedev temporary supervisor.¹⁶⁴

On December 3, 1998, Imperial's creditors held a meeting.¹⁶⁵ The majority of creditors voted to petition the court to declare Bank Imperial bankrupt and order the sale of assets.¹⁶⁶ In light of the temporary supervisor's accounting, which showed that Imperial's debts greatly exceeded its assets, the creditors decided that solvency could not be restored.¹⁶⁷ The majority of creditors also supported Medvedev's candidacy for receiver.¹⁶⁸ At the meeting, the creditors formed a five-member committee from the representatives of Zarubezhneft, London Forfeiting Cyprus, the Ministry of Fuel and Energy, LUKoil, and the Central Bank.¹⁶⁹ After the meeting, Imperial's President, Vladimir Farasenkov, urged the creditors to give the Bank a few more months to restore solvency, claiming Imperial's license "was recalled without the sufficient justification."¹⁷⁰

In accord with the claims that its license revocation was unjustified, Imperial appealed the Central Bank's order.¹⁷¹ On December 15, 1998, the Moscow Court of Arbitration suspended the bankruptcy proceedings until the court decided Imperial's appeal.¹⁷² Pending a decision on the license revocation, the court forbade Imperial from alienating its property and froze most of its accounts.¹⁷³

In early April 1999, the court rejected Bank Imperial's appeal.¹⁷⁴ Imperial "defiantly retorted that it had found 'masses' of errors in the license's confiscation just days after the Aug[ust] 17 crisis and would appeal to the top arbitration court."¹⁷⁵ The court scheduled the hearing on Imperial's fate for April 14, 1999.¹⁷⁶ But Imperial "succeeded in staving off bankruptcy hearings by filing an objection . . . to the judges on the case."¹⁷⁷ Addressing the claim of judicial impartiality, the court appointed new judges and postponed the hearing until May 25, 1999 to give them

163. *Bankruptcy of Imperial Suspended*, RUSS. BUS. MONITOR, Dec. 18, 1998, available at ISI Emerging Mkts., <http://www.securities.com>; IN BRIEF: *Imperial Loses Appeal*, *supra* note 153.

164. *Bankruptcy of Imperial Suspended*, *supra* note 163.

165. 12:45 MST *Creditors Agree to Bankruptcy of Imperial*, PRIME-TASS NEWS WIRE, Dec. 4, 1998, available at ISI Emerging Mkts., <http://www.securities.com>.

166. *Id.*

167. *Imperial Bankruptcy in Works*, INFO-NOVA PRESS DIG., Dec. 7, 1998, available at ISI Emerging Mkts., <http://www.securities.com>.

168. 12:45 MST *Creditors Agree to Bankruptcy of Imperial*, *supra* note 165.

169. *Id.*

170. *Imperial Bank Can Be Restored*, RUSS. BUS. MONITOR, Dec. 9, 1998, available at ISI Emerging Mkts., <http://www.securities.com>.

171. *Arbitration Court Suspends Bankruptcy Proceedings Against Imperial*, INFO-NOVA PRESS DIG., Dec. 17, 1998, available at ISI Emerging Mkts., <http://www.securities.com>.

172. *Id.*; *Creditors' Claims Against Imperial Bank Top 5 Bln Rubles*, *supra* note 162.

173. *Id.*

174. IN BRIEF: *Imperial Loses Appeal*, *supra* note 153.

175. *Id.*

176. *Creditors' Claims Against Imperial Bank Top 5 Bln Rubles*, *supra* note 162.

177. Borisova, *supra* note 157.

time to familiarize themselves with the case.¹⁷⁸ The court held the hearing on May 25 as scheduled, despite motions by LUKoil to further postpone the hearing because of alleged violations of bankruptcy law. The Moscow Court of Arbitration "declared the bank Imperial bankrupt, launched receivership procedures and appointed Vyacheslav Medvedev . . . as the bank's receiver."¹⁷⁹

On June 5, 1999, however, the Central Bank unexpectedly reinstated Imperial's banking license.¹⁸⁰ "The decision was preceded by two events: the appeal of the new Minister of Energy Resources Kalyzhny on the necessity to return to the bank its license, and the petition of major creditors of the bank - 'LUKOIL', 'GAZPROM' and 'ZARUBEZHNEFT' headed by the ministry - to the Central Bank."¹⁸¹ The creditors expressed a desire to participate in Imperial's recovery process,¹⁸² but none were willing to state what would constitute active participation.¹⁸³

Given the return of Imperial's banking license, the court's decision ten days earlier to liquidate became controversial.¹⁸⁴ On the one hand, the court had applied the Law on Insolvency of Credit Institutions to the case. That law specified that once a court declared a bank bankrupt, the parties could not seek external management or amicable settlement.¹⁸⁵ However, the law did not address the return of the institution's license.¹⁸⁶ On the other hand, Imperial's bankruptcy commenced while the Law on Insolvency regulated credit institutions. Under that law, an amicable settlement would be legitimate at any stage.¹⁸⁷ The court needed a solution to this judicial quandary: "The bank was declared bankrupt while its license was still valid."¹⁸⁸

Instead of resolving the issue, the Moscow Court of Arbitration simply reaffirmed the contradiction in the law. Early in July 1999, the court overturned the Central Bank's decision of August 25, 1998 to revoke Imperial's banking license.¹⁸⁹ Now, both administrative and judicial authorities considered Imperial's license valid. By regaining its license, Imperial set "a

178. *Id.*

179. 20:55 MST Bank Imperial Declared Bankrupt, PRIME-TASS NEWS WIRE, May 26, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

180. S. Petrova & M. Filimonov, *On Friday, June 5, The Central Bank of Russia Unexpectedly Returned to Imperial Bank Its License 10 Days After It Was Declared Bankrupt by the Arbitration Court*, BANKS & EXCHS., June 15, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

181. *Id.*

182. *Id.*

183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.*

187. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 120.

188. Petrova & Filimonov, *supra* note 180.

189. 20:44 MST Arbitration Court Annuls CBR Decision to Revoke License of Bank Imperial, PRIME-TASS NEWS WIRE, July 2, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

precedent for banks fighting to stave off bankruptcy.”¹⁹⁰

However, the court did nothing to resolve the controversy. Although it ruled Imperial’s license valid, the bankruptcy proceedings continued.¹⁹¹ In fact, “police were ordered to storm bank headquarters for financial documents,” which Imperial refused to turn over to Medvedev.¹⁹²

Finally, on July 27, the Moscow Court of Arbitration reversed its position and held invalid the Central Bank’s order to return Imperial’s banking license.¹⁹³ The court revoked the license, which it had returned only three weeks earlier. The Moscow Court of Arbitration is floundering, trying to both interpret the new laws and please Imperial’s powerful owners. Imperial will likely file an appeal with the higher arbitration court; thus, Imperial’s ultimate fate remains uncertain.

Unlike MENATEP, Imperial continues to fight for survival. Imperial’s owners did not have the time to strip its assets because the creditors started the proceedings earlier than those against MENATEP. Accordingly, Imperial’s owners have an incentive to restore solvency.

Imperial’s case shows that owners will try to save their banks when they have no opportunity to transfer assets. The drafters of the Law on Insolvency of Credit Institutions relied on that behavior, hoping that immediate supervision would protect the banks’ assets and encourage the investors to save the banks to preserve their personal assets. Moreover, Imperial’s case, started under the Law on Insolvency and prosecuted under the Law on Insolvency of Credit Institutions, illustrates the laws’ inconsistencies and the difficulty applying both laws concurrently or sequentially.

III. Imperfections of the New Laws and Suggestions for Improvement

As illustrated by these exemplary cases, the bankruptcy laws helped Russia to begin its recovery from the financial crisis of August 17, 1998 by empowering the Central Bank and creditors to declare insolvent banks bankrupt. Without these laws, creditors’ funds would remain frozen in debtor banks with no possibility of repayment or debt restructuring. Although a formidable advance over earlier legislation, the current bankruptcy laws are imperfect. These laws require further improvements to ensure that banks will be restructured or liquidated as soon as they become insolvent. If all insolvent credit institutions closed in a timely manner, the aftermath of another financial crisis could be minimized. Perhaps, if banks threatened by insolvency borrow and lend more carefully, Russia can prevent a future financial crisis from ever taking place.

190. Igor Semenenko, *Imperial Wins License but Bankruptcy Steps Continue*, MOSCOW TIMES, July 6, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

191. *Id.*

192. *Id.*

193. *Imperial Bank Regains Its License*, RUSS. BUS. MONITOR, July 30, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.

A. Imperfections of the Law on Insolvency

The first problem with the Law on Insolvency is the timeframe for appointing a temporary supervisor. Currently, the law requires the court to appoint a temporary supervisor within three days of initiating the bankruptcy proceeding.¹⁹⁴ While this short time period would be adequate for cases with few creditors, in cases involving thousands of creditors, such as those against insolvent banks, a longer period would benefit the majority of creditors.¹⁹⁵ Under the current law, the creditor who files first, often a powerful investor, exercises considerable influence over the choice of temporary supervisor and, thus, gains control of the bankruptcy proceedings.¹⁹⁶

The Law on Insolvency increases the probability of the first creditor's control by granting the temporary supervisor excessive authority with regard to recognizing claims.¹⁹⁷ The Law on Insolvency of Credit Institutions does not correct the problem.

[T]he temporary manager decides whether a creditor's claim is valid and what amount of the claim will be recognized. If the creditor objects to the temporary manager's action, he can appeal to the arbitration court. There, he will get a 20-minute hearing The decision of the arbitration court is not appealable any further.¹⁹⁸

Given the temporary supervisors' broad authority to recognize claims, they tend to abuse their power, often recognizing claims without proper documentation or rejecting legitimate claims.¹⁹⁹ A more elaborate appellate process may ameliorate this problem, but may, in turn, clutter the arbitration courts. Professionals, legal scholars, and politicians should determine the best solution to this problem.

Another problem left unresolved by the Law on Insolvency concerns the temporary supervisor's ability to undo preferential transfers made in contemplation of bankruptcy. Unlike earlier legislation, the Law on Insolvency includes a broad provision, article 78(3), for undoing preferential transfers, extending back six months.²⁰⁰ This provision allows "the temporary manager or the liquidator [to] set aside transactions in which the debtor transferred property to interested or affiliated parties or satisfied the claims of favored creditors ahead of the claims of others."²⁰¹ Practically, however, temporary supervisors and receivers do not use the provision, and the courts cannot supervise because they lack adequate access to information.²⁰² Better mechanisms for court or administrative supervision could overcome this difficulty in implementation. For example,

194. Yeltsin *Forced to Sign Bank Insolvency Law*, *supra* note 81.

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.*

200. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222, art. 78(3).

201. Yeltsin *Forced to Sign Bank Insolvency Law*, *supra* note 81.

202. *Id.*

requiring all the debtor's documentation to be stored in a place easily accessible to the court and the administration relieves this problem.

Commentators also criticize the law's other time limits and tax treatment. For instance, the timeframe between the bankruptcy petition and the creditors' meeting has proven insufficient to provide adequate consideration for all creditor claims.²⁰³ Moreover, some practitioners feel that the law's "one-year period for completing receivership is too short."²⁰⁴ Also, the law fails to specify whether the debtor must continue paying taxes after declared bankrupt.²⁰⁵ However, an amendment in the near future will likely fill this obvious gap.²⁰⁶

Finally, another problem concerns the amicable settlement procedure. The law specifies "that no amicable agreement can be approved by the court until documentation is presented showing that first and second priority bankruptcy claims have been settled in full."²⁰⁷ In other words, the debtor must satisfy tort and wage claims before any restructuring agreement with other creditors. In addition, the debtor cannot settle government claims for unpaid taxes, but may need to satisfy those claims in full after any amicable settlement, often making an agreement impracticable.²⁰⁸ These features create a significant roadblock for many debtors, preventing amicable agreements with creditors.²⁰⁹ Removing this obstacle involves the elimination of mandatory satisfaction for some claims prior to any agreement and requires permission to settle tax claims by agreement.

B. Imperfections of the Law on Insolvency of Credit Institutions

First, many practitioners consider the Central Bank's authority under the Law on Insolvency of Credit Institutions problematic.²¹⁰ The law fails to specify clearly "where the supervisory authority of the Central Bank ends and the primary jurisdiction of the court begins."²¹¹ As under the Law on Banking, the Central Bank's authority continues even after it revokes an institution's banking license.²¹² Practitioners believe that overlapping the Central Bank's and the judiciary's authority creates confusion.²¹³ They suggest that the Central Bank's authority should end after it revokes a

203. *Practitioners Struggle With Gaps in the Russian Bankruptcy Law*, RUSS. & COMMONW. BUS. L. REP. (LRP Publ'ns), Feb. 10, 1999, available at LEXIS, 2ndary Library, NWLTRS File.

204. *Id.*

205. *Id.*

206. *Id.*

207. *Workouts May Become More Frequent in Russia*, RUSS. & COMMONW. BUS. L. REP. (LRP Publ'ns), Feb. 10, 1999, available at LEXIS, 2ndary Library, NWLTRS File.

208. V. Vitryanskiy, *Kak Reformirovat' Zakonodatel'stvo o Bankrotstve* (How to Reform Bankruptcy Law), ZHURNAL ZAKONOD., May 3, 1999, available at Garant, http://www.garant.ru/jorn/leg_3_05_99.htm.

209. *Id.*

210. *Yeltsin Forced to Sign Bank Insolvency Law*, *supra* note 81.

211. *Id.*

212. *Id.*

213. *Id.*

bank's license.²¹⁴

Moreover, in supervising bankruptcy proceedings, the Central Bank faces a profound conflict of interests. Many Russian banks are insolvent, and the Central Bank should revoke their licenses. Decreasing the number of operating banks, however, diminishes the Central Bank's zone of authority; "if every bank goes bankrupt, the Central Bank will have nothing to regulate."²¹⁵ Also, the Central Bank, as a major creditor of many large banks, may benefit from their prolonged existence.²¹⁶ Accordingly, the Central Bank's authority to initiate and supervise bankruptcy proceedings against credit organizations should be reduced or eliminated.

Furthermore, the Central Bank's authorized measures for saving ailing banks may be insufficient. Under the Law on Insolvency of Credit Institutions, the Central Bank may request that the bank's investors provide financial assistance, but cannot enforce its request.²¹⁷ A regulation requiring shareholders to invest capital in the ailing bank prior to reorganization may facilitate the restoration of banks by their own investors.

The final major criticism of the Law on Insolvency of Credit Institutions concerns amicable settlements. Article 5(2) removes the parties' ability to reach amicable settlement during liquidation, an ability provided for by the Law on Insolvency.²¹⁸ Some practitioners consider this clause a violation of article 421 of the Civil Code and a restriction on the freedom of contract.²¹⁹ In light of these potential conflicts, they urge the government to reconsider the provision. Although the government may reconsider the provision, it will most likely decline to redraft the Article because its alteration in 1999 seemed well considered and deliberate.

C. Conflicts of Laws

Conflicts among the new bankruptcy laws cause many of the problems with these laws' operation. The Law on Insolvency, the Law on Insolvency of Credit Institutions, and the Banking Law all regulate the insolvency of banks.²²⁰ The following examples illustrate a few of the conflicts. First, the Law on Insolvency lists the actions that a bank undergoing judicial review can take during the observation period with the temporary supervisor's consent.²²¹ "The Banking Law, which also applies, has a different list of what banks can do after they have lost their license."²²²

214. *Id.* ("Doesn't revocation of a license mean there is no bank to supervise?" (quoting a Moscow lawyer)).

215. *Id.*

216. *Russia Regulations: Bankruptcy Law Comes Into Force*, *supra* note 89.

217. *Yeltsin Forced to Sign Bank Insolvency Law*, *supra* note 81.

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.* (quoting a Moscow lawyer). The Law on Banks and Banking Activities specifies that when the Central Bank withdraws a bank's license: (1) its debts become due; (2) the accrual of interest and fines on the bank's debt terminates; (3) a moratorium begins with respect to all of the bank's obligations, except for those mandated by court judgments for collection of wages, royalties, alimony, and tort damages rendered prior to

Second, unlike the Law on Insolvency of Credit Institutions, the Law on Insolvency provides for an observation stage.²²³ In accord with the Law on Insolvency's language, the Law on Insolvency of Credit Institutions prevails.²²⁴ Judicial decisions, however, suggest that judges tend to give banks a short period of time similar to the observation stage provided by the Law on Insolvency. To solve these conflicts between the bankruptcy laws, the Duma should appoint a special committee to harmonize the laws applicable to bankruptcies, in particular bankruptcies of credit institutions.²²⁵

D. Implementation of Laws

The Law on Insolvency and the Law on Insolvency of Credit Institutions are imperfect. Moreover, they often conflict with each other and other legislation. Legislators can eliminate these conflicts and imperfections through amendments and directives clarifying the laws, which should be the product of careful study and deliberation by experts and legislators. In addition, the laws need a better system of implementation to ensure the proper functioning of the Russian bankruptcy system in the future. The judges of the lower arbitration courts need more experience to understand and interpret the bankruptcy laws. Moreover, the government needs to train more qualified arbitration managers, and the Central Bank and other governmental entities need to settle their power struggle for control of bankruptcy proceedings. Resolving these practical problems will enable the Russian bankruptcy system to function smoothly and efficiently.

Conclusion

The Law on Insolvency and the Law on Insolvency of Credit Institutions constitute a formidable step forward in Russia's move toward a free-market economy. These laws provide insolvent banks, as well as other enterprises and individuals, with exit and restructuring mechanisms. By enabling creditors to recover some of their debts and solvent banks to grow and ultimately replace insolvent giants, the new laws pave the way for a more efficient banking system.

The new bankruptcy laws have helped Russia to begin its recovery from the financial crisis of August 17, 1998. This recovery, however, will take years to complete. In mid-1999, the Central Bank estimated that over three hundred Russian credit organizations remained insolvent without

the license withdrawal; and (4) the bank ceases payments under its current contracts, except payments for utilities, maintenance, and under labor contracts, until a liquidation commission is formed or an arbitration manager is appointed by the court. *Sobr. Zakonod. RF*, 1996, No. 6, Item 492. This list differs markedly from banks' permissible actions without a license during the observation period. *See supra* notes 53-68 and accompanying text.

223. Yeltsin *Forced to Sign Bank Insolvency Law*, *supra* note 81.

224. *Sobr. Zakonod. RF*, 1998, No. 2, Item 222.

225. Politicians and practitioners should decide the difficult problem of harmonizing the laws; it is outside the scope of this Note.

undergoing reorganization or liquidation.²²⁶ In October 1999, the Central Bank contemplated revoking about two hundred banking licenses within the following year.²²⁷ Thus, the clean-up job for the bankruptcy laws is still in its initial stages. These laws need to be improved; but what is on paper ought to be translated into action and implementation in order to revitalize Russia's economy and rebuild the financial sector in the hopes of preventing future crisis.

226. *Banking Sector Problems Analysed*, BBC SUMMARY OF WORLD BROADCASTS, June 18, 1999, available at LEXIS, News Library, ALLNWS File.

227. 14:50 MST CBR to Withdraw Licenses of 200 Banks Within a Year (Follow-Up), PRIME-TASS NEWS WIRE, Oct. 6, 1999, available at ISI Emerging Mkts., <http://www.securities.com>.